CORPORATIONS: EFFECT OF CONSTRUCTIVE NOTICE TO CREDITORS OF ISSUE OF STOCK AT A DISCOUNT IN SUIT AGAINST STOCKHOLDERS—The leading case in California establishing the liability of a stockholder when stock is issued at a discount, to pay the difference between the issue value and par value to a creditor of the corporation, was not decided until 1902.[1] Since that time, although the general rule is well settled, it has been considerably modified by subsequent decisions. The rule has been held to apply where stock was issued, not for money, but for property at a known overvaluation at the time of issue;[2] it applies even where the books of the corporation show that the stock is issued as fully paid;[3] and it has been held, overruling an earlier decision, that the rule is applicable as well to mining corporations as to others.[4] The rule is also followed where the overvaluation was so grossly excessive as to be a constructive fraud on creditors, even though the directors honestly believed the valuation to be a correct one.[5] On the other hand, it has been held that in the absence of fraud, there is no liability where the property for which the stock was exchanged had no ascertainable value,[6] and that the rule does not apply where the stock was issued absolutely without consideration, for then the stock is pure bonus, and the issue is void as "fictitious."[7] The rule is not applicable where the corporation is a going concern and, becoming embarrassed, increases its capital stock in good faith for the best price obtainable.[8] It is also held that a creditor who has full knowledge of the fact that the issue was made at an overvaluation cannot later complain.[9]

Mills v. Brady[10] goes further than any of these cases, and indeed further than any case that has been found in the United States, in the direction of exempting the stockholder from this liability under statutes similar to those in California. Here it was held that a stockholder who had advanced money in a col-

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[1] Vermont Marble Co. v. Declez Granite Co. (1902) 135 Cal. 579, 67 Pac. 1057, 87 Am. St. Rep. 143, 56 L. R. A. 728.

[2] Herron Co. v. Shaw (1913) 165 Cal. 668, 133 Pac. 488, Ann. Cas. 1915A 1265, 1 California Law Review, 540.

[3] Home Savings Bank v. Los Angeles City R. Co. (1917) 176 Cal. 731, 171 Pac. 290.

[4] Hasson v. Koeberle (1919) 57 Cal. Dec. 458, 181 Pac. 387; Zierath v. Claggett (1920) 31 Cal. App. Dec. 420, 188 Pac. 837, 8 California Law Review, 253, rejecting the doctrine of the famous case of In re South Mountain Co. (1881) 5 Fed. 403, (1882) 14 Fed. 347.

[5] Zierath v. Claggett, supra, n. 4.

[6] Harrison v. Armour (1915) 169 Cal. 787, 147 Pac. 1166.

[7] J. F. Lucey Co. v. McMullen (1918) 178 Cal. 425, 173 Pac. 1000; Kellerman v. Maier (1898) 116 Cal. 416, 48 Pac. 377; and see Cal. Const. Art. XII, § 11, and Cal. Civ. Code, § 332.

[8] J. F. Lucey Co. v. McMullen, supra, n. 7, upsetting though not mentioning the contrary implication in Merchants Mutual Adjusting Agency v. Davidson (1913) 23 Cal. App. 274, 137 Pac. 1091.

[9] Sherman v. Harley (1918) 178 Cal. 584, 174 Pac. 901, 7 A.L. R. 950, 6 California Law Review, 463.

[10] (July 8, 1920) 32 Cal. App. Dec. 771; hearing in the Supreme Court granted (Sept. 2, 1920); pending.

lateral transaction was barred from recovery as a creditor against other stockholders who had purchased stock at a discount, on the grounds that because as a stockholder he had access to the corporate books and because he was thus charged with "constructive knowledge" of the facts surrounding the issue of the stock, his claim came within the rule of Sherman v. Harley, supra. The case is not one of actual knowledge. There was no evidence that the plaintiff consented to or acquiesced in the agreement that the stock should be considered as fully paid, nor does the opinion disclose when or for what price he bought the stock.

The rule thus announced seems objectionable for two reasons. In the first place, it may well be doubted whether in any proper sense the mere access to the books of the corporation can be deemed to impart constructive knowledge, especially as to transactions that occurred prior to the time when the person sought to be charged with this notice became a stockholder.[11] It would seem absurd to charge a person who purchased stock at a stock exchange with notice of the contents of a minute book which might be in an office on the other side of the continent, yet such would be the effect of the rule.

Even assuming, however, the fact of constructive notice, is not the principal case still subject to criticism? Whether even actual knowledge should bar the creditor would seem to depend upon what theory the stockholder's liability is based — "holding out," "trust fund" or on a statute.[12] Strictly speaking, knowledge of the creditor should be immaterial under the "trust fund" theory, and while the present writer holds no brief for that artificial and somewhat outworn excuse for judge-made law, it has been, apparently, the basis of the California decisions. Nevertheless, while the general rule is unquestionably to the effect that actual knowledge is a bar,[13] constructive notice is far from actual knowledge.[14] Where a statute, however, contains a positive man-

[11] Cf. 6 Fletcher, Cyclopedia Corporations, § 4043, and cases therein cited, holding that aside from knowledge of the provisions of the by-laws a stockholder is not charged with constructive knowledge of corporate acts, unless he also holds some official position that would charge him with such knowledge.

[12] See as to the general theory of the stockholder's liability to creditors for unpaid subscriptions, 2 California Law Review, 237; 29 Harvard Law Review, 854; 13 Yale Law Journal, 66; 49 Central Law Journal, 284; 56 University of Pennsylvania Law Review, 57; 62 Id. 133; 4 Virginia Law Review, 131.

[13] As to the effect of notice in general, see notes in 10 Ann. Cas. 90, and 7 A. L. R. 972, 8 L. R. A. (N. S.) 271; also First National Bank v. Gustin etc. Co. (1890) 42 Minn. 327, 44 N. W. 198, 18 Am. St. Rep. 510, 6 L. R. A. 676.

[14] In 5 Fletcher, Cyclopedia Corporations, § 3595, it is said that a creditor who has actual or constructive knowledge of the circumstances under which the stock was issued is barred from recovery on a suit for unpaid subscriptions issued as fully paid. Of the twenty cases cited to support this proposition, nineteen were cases of actual knowledge. The remaining case is Bent v. Underdown (1901) 156 Ind. 516, 60 N. E. 307, where it was held that the filing of the recorded articles of incorporation which expressly provided that only a certain per cent of the value of the stock should be collected, prevented the stockholder's liability being an asset of the corporation. That this case is not

date to pay the par value of the stock, knowledge of the creditor as to the facts of the issue is immaterial.[15]

The effect of the decision in the principal case is really to prevent a stockholder from ever acquiring the rights of a creditor to enforce liability for unpaid subscriptions in any case where the corporate records reveal the fact that the stock was issued as fully paid. This is a startling result, because it is well settled as a general rule that a stockholder who becomes a creditor has the same rights as any other creditor.[16] It has been decided in California that even a stockholder who is indebted on his own subscription can, as a creditor, compel other stockholders to pay the amount owed to the corporation on unpaid subscriptions in satisfaction of his debt.[17] The only limitation on these rights is in the case where the creditor was a stockholder who acquiesced or participated in the issue of the discounted stock as fully paid or where the creditor in such a situation had actual knowledge of the facts. The authorities cited by the court in the principal case were all cases either of actual knowledge or participation in the transaction.

Another aspect of the case remains to be discussed. There was a second group of creditors bringing suit who were not stockholders, but who performed legal services for the corporation. It appeared that they knew that the stock was issued below par, but were told that there was still a balance owing up to the par value. It would seem that the knowledge that would bar a creditor in a situation of this sort must include the fact that the stock was issued as paid in full. The principal case, however, holds that mere knowledge that the stock was issued below par prevents recovery by the creditor even where he was informed or perhaps misinformed that the stock was not issued as fully paid. The opinion argues that misrepresentations could not impose liability on other innocent stockholders; that the plaintiffs chose to rely not on the official records of the corporation but on the representations of the men with whom they dealt, and could not complain. This statement is also open to objection. The liability of the stockholders sought to be imposed is in no way dependent

applicable needs no argument; moreover, this situation could not arise in California in view of the provisions in our Constitution regarding the issue of stock at a discount, supra, n. 7. Furthermore, the Underdown case was criticised and its reasoning rejected in Security Trust Co. v. Ford (1906) 75 Ohio St. 322, 79 N. E. 474; and Lea v. Iron Belt Mercantile Co. (1898) 119 Ala. 271, 24 So. 28, 8 L. R. A. (N. S.) 279, is contra.

[15] Easton National Bank v. American Brick etc. Co. (1906) 70 N. J. Eq. 732, 64 Atl. 917, 8 L. R. A. (N. S.) 271, 10 Ann. Cas. 84; Rosoff v. Gilbert (1915) 221 Fed. 972.

[16] 6 Fletcher, Cyclopedia Corporations, §§ 4045, 4046.

[17] Blood v. La Serena Land etc. Co. (1907) 150 Cal. 764, 89 Pac. 1090, and see note in 41 L. R. A. (N. S.) 981. And where a creditor is entitled to be subrogated to the rights of the corporation to claim unpaid balances due on shares, it is immaterial that he is also a stockholder unless he actually participated in the transaction. Richardson v. Chicago Packing Co. (1900) 6 Cal. Unrep. Cas. 606, 63 Pac. 74.

upon any representations made by third parties, but solely on the grounds that they accepted the stock issued for less than par. The obligation to pay par value for the benefit of creditors is based not on fraud but primarily on statute. Unless the creditor who is seeking to enforce that liability had knowledge of an agreement that the stock was issued as fully paid, he should be able to invoke the general rule. And the burden, moreover, of proving that knowledge should be on the defendant.[18] Nor was he in any way charged with notice by the records of the corporation, because until he became a creditor he had no right to inspect the corporate books. As to third persons, the books of the corporation are private books.[19] It is submitted that the salutary rule laid down in the Vermont Marble case should be limited no further than the exception of Sherman v. Harley, that only a creditor who has actual knowledge that the discounted stock was issued as fully paid may not recover the unpaid balance from the stockholders. *H. A. B.*

DELIVERY OF DEEDS: CONDITIONAL DELIVERY TO THE GRANTEE —Though it seems to have been a well-settled rule in California that where a grantor delivers his deed to the grantee, without any express reservation of the right to recall it, and with intent that in a certain contingency it shall be effective without any further act on the part of the grantor, such delivery is effectual to pass title presently,[1] and though it is so provided in the code,[2] the rule was apparently overlooked in the case of *Gaschlin v. Sierra*.[3]

In this case, the grantor caused a deed to be made to the plaintiff as grantee, which he signed and acknowledged before a notary, and taking the plaintiff with him to the safe deposit vault, handed the deed to the plaintiff, saying, "This is what the old man has done for you. This is yours." The plaintiff read the deed through and handed it back to the grantor, who then asked

[18] Herron v. Shaw, supra, n. 2; Johns v. Clother (1914) 78 Wash. 602, 139 Pac. 755.

[19] National Bank etc. v. Western Pacific Ry. Co. (1910) 157 Cal. 573, 108 Pac. 676, 27 L. R. A. (N. S.) 987; Gilkie etc. Co. v. Dawson Town etc. Co. (1895) 46 Neb. 333, 64 N. W. 978, 1097. Cal. Civ. Code, § 378, limits the right of inspection of the corporation's books to directors, stockholders and existing creditors, the public at large having no such right.

[1] See 2 Devlin on Deeds, § 314; Mowry v. Heney (1890) 86 Cal. 471, 25 Pac. 17; Kenniff v. Caulfied (1903) 140 Cal. 34, 73 Pac. 803; King v. Fragley (1912) 19 Cal. App. 735, 127 Pac. 813; Hammond v. McCullough (1911) 159 Cal. 639, 115 Pac. 216; Follmer v. Rohrer (1910) 158 Cal. 755, 112 Pac. 544; Lewis v. Brown (1913) 22 Cal. App. 38, 133 Pac. 331; Fisher v. Fisher (1913) 23 Cal. App. 310, 137 Pac. 1094; Bias v. Reed (1914) 169 Cal. 33, 145 Pac. 516; Hefner v. Sealey (1917) 175 Cal. 18, 164 Pac. 898.

[2] Cal. Civ. Code, § 1056. "A grant cannot be delivered to the grantee conditionally. Delivery to him, or to his agent as such, is necessarily absolute, and the instrument takes effect thereupon, discharged of any condition on which the delivery is made."

[3] (June 3, 1920) 32 Cal. App. Dec. 462.